COASTAL SECURITIES, INC.

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January 28, 2015

The Honorable Ivy R. Taylor, Mayor
City of San Antonio
City Hall
100 Military Plaza
San Antonio, Texas 78205

Dear Mayor Taylor:

Coastal Securities, Inc. has been asked to assess the potential impact of the adoption of certain proposed legislative changes to the City of San Antonio Fire and Police Pension Fund upon the underlying general obligation bond ratings of the City of San Antonio.

As you are well aware, the City of San Antonio currently enjoys the highest possible ratings of "Aaa," "Aaa" and "AAA" from the national rating services, Fitch Ratings, Moody's Investors Service, and Standard & Poor's, respectively. These ratings represent the agencies' current opinion of the financial, economic and administrative position of the City of San Antonio relative to its ability to satisfy financial commitments. Moody's Investor Service currently has a negative outlook on the City rating, thereby making any action by the City which may appear adverse to the City's position that much more significant.

The attainment of the these ratings for the first time in the City's history in 2008, and the subsequent reaffirmation of such ratings, is the result of years of dedicated, disciplined and consistent management and control of the City's finances, as well as the ability and willingness of the City to react to factors both within and outside of its control in order to preserve its financial position. While the municipality may not be in control of all of those variables which may affect its financial position, it should be in control of how it reacts to those variables. The rating agencies will assess whether the municipality has controlled those factors that it can control in order to preserve its financial position.

Rating agencies assess numerous factors which affect the underlying ratings for the City. While many of these factors are weighed more significantly than others, each are considered important in the rating process, and have the potential to affect the rating in either a positive or negative manner when taken in context with other variables.

FINANCIAL CONSTRAINTS

For the past 20 years, the City of San Antonio has operated under a series of self-imposed financial constraints which have defined its financial position. Foremost among these considerations has been the desire to maintain and not increase the ad valorem tax rate. In tax year 1994-95, the aggregate ad valorem tax rate was $0.57979 per hundred dollar valuation; for the current 2014-15 fiscal year the rate is $0.56569. While the city has the legal authority to levy well above the current levy, it has chosen not to increase the rate.

While it is certainly within the purview of the City Council to react to certain financial factors by raising ad valorem taxes, an action over which they have total control, we will predicate our assessment upon the continued desire to maintain the tax rate.

DEBT AMORTIZATION

The City has adopted a formal Debt Management Plan which provides for a systematic approach to the issuance of debt relative to all of the capital demands of the City over a long-term multi-year basis. This plan layers debt over the years within certain constraints. Among these constraints are: maintenance of the debt service tax rate; issuances limited to no more than a 20-year amortization (in 2010, the City issued 30-year Build America Bonds supported by federal subsidy as an exception to this constraint); preservation of future debt capacity within the tax rate so as to not limit the ability to respond to future capital demands; and maintenance of an average life of no more than 10 years.

LEGISLATIVE PROPOSAL

The Fire and Police Pension Fund Proposed 2015 Legislative Package includes several proposals. Among these proposals are:

1. 100% COLA to all members who retired between Oct. 1, 1999 and Sept. 30, 2003
2. Board discretion to adjust the date for a 100% COLA
3. Reduce disability pension from 50% to 47.5%
4. Max years allowed for BackDROP from 34 to 33 years
5. Reduce City Contribution rate from 24.64% to 23.25%
6. Changes to the Uniform Pension Benefit Formula

It is our understanding that these actions would serve to increase the unfunded liability by some $72 million, while simultaneously increasing the years needed to amortize unfunded liability from 7.25 to 12.87. However, given the nature of the Pension Board being allowed full discretion over the adjustment of COLAs moving forward, the full impact of this decision cannot be determined.

DEBT POSITION

Rating agencies regard the burden of pension benefits for major municipalities as a growing concern. For many major municipalities, the long-term financial implication of pension liability far exceeds the direct debt burden. Major pension issues have erupted into significant financial problems for multiple major municipalities. In light of this trend towards increasing major municipalities' pension liabilities, and in reaction to recent adoption of changes in market valuation of assets by GASB, Moody's has moved to an Adjusted Net Pension Liability measure.

As of recent issuances of City of San Antonio general obligation debt, and the most recent reviews of the general obligation ratings by the major rating agencies, the City of San Antonio enjoys a favorable position in regards to both its debt burden and liabilities for pension and OPEB when compared to the three other major Texas municipalities of Austin, Dallas and Houston.

Key Statistics*	San Antonio	Austin	Dallas	Houston
Moody's 3 year ANPL/Full Value	2.47%	3.04%	6.07%	5.01%
Moody's 3 year ANPL/Operating Revenues	1.44%	2.88%	4.52%	3.99%
Net Direct Debt/Full Value	2.73%	1.70%	2.00%	1.84%
Net Direct Debt/Operating Revenues	1.59%	1.66%	1.49%	1.46%
Moody's Rating	"Aaa"	"Aaa"	"Aa1"	"Aa2"

* Compiled from Moody's Investor Service Ratings Reports for the respective municipalities.

These four factors account for a full 20% of the rating factor weighting for Moody's Investors Service, while given a 10% weight by Standard & Poor's.

While the proposed legislative changes would add some $72.6 million to the unfunded liability, this would represent an increase of some 31.1% in unfunded liability. More significantly, turning over the ability to determine the date of the 100% COLA would leave the determination of future obligations in the hands of a third party and not City Council. While such an increase would not in itself create such a significant deterioration of credit quality to unilaterally affect ratings, it would be one variable for consideration.

MANAGEMENT

Each of the rating agencies views management as a key consideration in the rating process. The willingness and ability of the municipality to unilaterally react to outside forces which may affect the financial position of the City is a significant consideration. Both Moody's Investors Service and Standard & Poor's place a full 20% weight on the issues of management.

> "Guided by a strong and experienced management team, the city's financial management incorporates the use of multiyear budgeting practices which has become institutionalized, and five year financial forecasting." *Moody's Investors Service, City of San Antonio, Texas Rating Report, August 14, 2014*

> "San Antonio's management conditions are very strong, in our view with 'strong' financial practices under our Financial Management Assessment (FMA) methodology, indicating practices are, in our opinion, strong, well embedded and likely sustainable." *Standard & Poor's Rating Service, City of San Antonio, Texas Rating Report, Dec.1, 2014.*

Fundamental to this assessment is the propensity of the City to plan for its eventual financial obligations as reflected by Moody's:

> "The Aaa rating reflects the city's expected improved financial position at fiscal year end 2014 as well as a fiscal year 2015 budget that is anticipated to be balanced. The rating also incorporates the city's financial management that includes multiyear budgeting practices and conservative budget assumptions, strengthened financial policies, and financial flexibility that incorporates additional reserves outside the General Fund and ample taxing margin."

> "Guided by a strong and experienced management team, the city's financial management incorporates the use of multiyear budgeting practices which has become institutionalized, and five year financial forecasting. Additionally, the city recently strengthened its financial policy to maintain a minimum reserve of 10%, up from the 9% previously adopted. Additionally, the financial policy calls for a budget reserve of between 1% and 3% for the second year in the budget cycle, as well as a $1 million General contingency and a $3 million capital contingency. As such, the city expects to maintain a minimum target of 15% in reserves." *Moody's Investors Service, City of San Antonio, Texas Rating Report, July 24, 2014.*

Within the "Aaa" category the expectation to exceed minimum expected standards of funding is implicit.

The independent ability of the City to respond to financial consideration is a critical consideration in this assessment. Any consideration that the City would relegate decision making authority to a third party on issues which may have a significant budgetary or financial impact on the City will be viewed as a significant problem to the rating agencies.

> "The decentralized and autonomous nature of U.S. local governments creates a strong link between management and credit quality, particularly when weak management exists." *Standard and Poor's, U.S. Public Finance: U.S. Local Governments General Obligation Ratings: Methodology and Assumptions, Sept. 12, 2013.*

The premise of the autonomous nature of the municipality reflects the requirement that the ability of the City to respond rests solely in the hands of the decision making parties of the municipality.

By allowing certain key decisions to be made by the Pension Board which would directly affect the budgetary demands of the City, as in the case of the Board discretion to adjust the date for a 100% COLA, such a decision would run contrary to the valuation of the management criteria. This is further illustrated by Moody's: "Other considerations not on the scoreboard that may lead to scoreboard adjustments: Labor contracts that materially affect credit strength." *Moody's Investors Service, U.S. Local Government General Obligation Debt, Rating Methodology, Jan. 15, 2014.*

A subcomponent of the Moody's matrix is the consideration for institutional framework. This consideration makes up a full 10% of the Moody's rating. "This score measures the municipality's ability to match revenues with the expenditures based on its institutional apparatus: the constitutionally and legislatively conferred powers and responsibilities of the local government entity." *Moody's Investors Service, U.S. Local Government General Obligation Debt, Rating Methodology, Jan. 15, 2014.* The legislature attributing determination of certain budgetary factors by the Pension Board would run in direct conflict with the institutional framework consideration. This point is further illustrated by Fitch Ratings: "We believe management of pension benefits and funding frameworks is particularly meaningful in our analysis when the government has some level of authority over both sides of the equation-determining benefits and paying for them." *Fitch Ratings, Local Government Pension Analysis, April 8, 2013.*

RECENT RATING AGENCY REPRESENTATIONS TO THE CITY OF SAN ANTONIO

In the course of recent reviews of the City of San Antonio general obligation bond ratings, certain representations have been made which lead City staff to exercise all due caution and deliberation in taking any steps which may be viewed as impeding the credit quality of the City. The current Negative Outlook alone, assigned by Moody's Investors Service, has proven an issue of constant consideration and reflection.

> "The rating also incorporates the city's financial management that includes multiyear budgeting practices and conservative budget assumptions, strengthened financial practices and conservative budget assumptions." *Moody's Investors Service, City of San Antonio, Texas, July, 24, 2014.*

> "The City's management team has designed a long term capital improvement planning (CIP) program that is updated annually. The CIP included plans for future debt issuances in order to meet ongoing capital needs…

> "…Typically, the city's practice is to schedule debt retirement within 20 years of the issuance. We note that this practice is favorable and consistent with the "Aaa" rating. Ongoing conservative debt management should allow the city to layer in future debt without negatively impacting the direct debt burden." *Moody's Investors Service, City of San Antonio, Texas, July, 24, 2014.*

Over the past several years, the issue of pension obligations has been a source of discussion with the rating agencies, "the rating reflects slightly elevated debt burdens for the rating category, and; given current plans for pension adjustments, manageable long-term liabilities for pension and OPEB." *Moody's Investors Service, City of San Antonio, Texas, July, 24, 2014.*

> "Moody's focus is the evaluation of credit risk of rated debt obligations. Because pensions represent material financial commitments that affect a government's financial risk profile, we have always incorporated pensions into our credit analysis where we have been aware of significant unfunded liabilities. As pension stress began to be a driving factor in a number of government rating downgrades over the past few years, we recognized a need to bring greater transparency and comparability to the pension measures used in our analysis." *Moody's Investors Service, Cross Sector Rating Methodology. Adjustment to US State and Local Government Reported Pension Data, April 17, 2013.*

> "Right now, the city faces a $27.4 million gap in fiscal year 2015 that is expected to be closed with the combination of department cuts and savings from the ongoing negotiations with the public safety group. While the anticipated 2014 results are positive, a demonstrated trend of structurally balanced operations is needed to remove the negative outlook." *Moody's Investors Service, City of San Antonio, Texas, July, 24, 2014.*

Any movement toward placing decision making authority over certain budgetary matters in a third party will be regarded as contrary to a movement toward structural balance.

CONCLUSIONS

A determination as to the impact of the proposed legislative changes to the Fire and Police Pension Fund upon the underlying general obligation bond ratings of the City of San Antonio must be viewed through the context of the existing ratings and status of each of the respective rating agencies.

- The current Negative Outlook assigned by Moody's Investors Service represents challenges to the City, even before consideration of the proposed legislative changes.
- While the increase to unfunded liability and years to amortize unfunded liability alone should not lead to rating changes, they will place additional pressure on calculated measures.
- Any legislative action which allows any third party to obligate the City of San Antonio to additional financial considerations will be regarded as inconsistent with the Managerial Control principals' characteristic of a "Aaa," "AAA," "Aaa" rated city.
- The inability of the City of San Antonio to unilaterally control COLAs, while extending the number of years to amortize the unfunded liability raises the risk of adversely affecting budgets, fund balance or a combination thereof, thereby adversely affecting credit quality.
- The lack of predictability in forecasting financial obligations is inconsistent with the City of San Antonio's long-term financial planning techniques which are a significant consideration for the rating agencies in determining the "Aaa," "AAA," "Aaa" ratings.

While any rating action is the result of multiple factors being taken into consideration, the ability and willingness to plan for financial impacts, project anticipated obligations and directly control the outcome of such variables is consistent with "Aaa," "AAA," "Aaa" ratings. Given the nature of many of the proposed legislative changes, and their inherent contradiction of many of the basic criteria used in arriving at the existing ratings for the City of San Antonio, it is our belief that given the current rating environment, the adoption of such proposed changes may result in the downgrade of the City of San Antonio's "Aaa," "AAA," "Aaa" rating by one or more of the major municipal bond rating agencies. Given the lag time in reporting UAL, annual Pension Fund results, and the growth of retiree base, such an effect may not be imminent, but may be realized in the near term.

Sincerely,

Jorge Rodriguez
Head of Public Finance
Managing Director

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